Module V: Establishing an Emergency Fund

Summary: *In this lesson, we will discuss how to save money to develop a personal emergency fund. This is a crucial piece of the puzzle that will assist you in your quest for financial independence. The key to establishing an emergency fund is putting away money on a consistent basis and having the discipline not to touch it. This money can then be used as a fallback when you are experiencing financial hard times, saving you from tapping into your investment programs to get money. Establishing this fund will also allow you to stop living from paycheck to paycheck. It does require discipline to acquire the savings, but the rewards are well worth it.*

One of the biggest problems people have managing money is that they live from paycheck to paycheck and never save any money. The average savings rate for the United States is often below zero percent – this is caused by excessive debt. Many people never get any closer to realizing their financial goals, and they have a hard time getting cash in a crisis. Your emergency fund will actually become a buffer for your investments by providing a reliable source for getting money quickly in a crisis or emergency. By definition, an emergency fund contains enough money to pay for any unexpected expenses and enables you to avoid being forced to sell or 'liquidate' financial assets like mutual funds, stocks or bonds.

The first and most important rule is to pay yourself first. When you are paying your bills, do not put yourself last--you may never get there. The first check to make out each pay period is to yourself. Put it in a bank account or a secured liquid investment (investments that can easily be converted to cash). An excellent way to accomplish this goal is to set up an automatic allotment or automatic bank draft to a bank account or some other secured investment (e.g. bank or mutual fund money market account, short term certificate of deposit, etc.) that can quickly and easily be converted to cash without penalties. Put it someplace 'out of sight'- a different bank from the one your normal accounts are in or some other secure place earning interest (not under your bed mattress).

The worst way to try to save money is to wait until you pay all your bills and sock away what's left. Chances are if you do it that way, nothing will ever get saved, because there will never be any money left to save. Waiting until the end of the month to deposit what is left of your paycheck will not get you there.

If you pay yourself first, you will have less money available for impulse purchases. Impulse purchases are unplanned purchases you buy when you are ‘caught up in the moment.’ Ask yourself this: When you went to the PX and came back with six compact disks, did you really plan to buy them or were you ‘caught up in the moment’? The answer probably is that it was an impulse purchase. Now, if you were waiting until the end of the month to save the money that was left over, there would not be much (if there was any at all!) to put in savings. The six compact disks may bring some quick pleasure, but they will not be able to help you when you have an emergency situation and you need the money (you could sell the CDs, but you would be lucky to get even a third of the value you paid- whereas an emergency account would have the whole amount plus whatever interest it earned).

Asking some easy questions will help you evaluate your purchases. Did I really plan to buy this? Do I really need this? Am I buying this just because I am trying to keep up with someone else? If you paid yourself first, you would not have this dilemma because by the end of month you probably couldn’t afford those CDs. If you could afford them, you wouldn’t have to feel guilty about buying them because you already met your savings goal. Paying yourself first is the only way to go.

Pennies can add up--and so will nickels, dimes, quarters and dollars. The key is to save them. A good rule of thumb is to save about 10 percent of your paycheck first and put it into your dedicated emergency fund account. The recommendation of most financial experts is to keep three to six months' worth of expenses on hand in a quickly accessible reserve account. Once you have achieved this goal, you can start considering some higher return investments like mutual funds, stocks, bonds, etc. Again, the emergency fund offers you a first line of defense against being forced to tap into your investments in these types of assets. The stock market can be very volatile and you never want to be forced to sell in a down market when your investments may be losing money.

“But I don’t make a lot of money, how can I afford to save money?” Use the ’pay your self first‘ method to cut out impulse purchases. If this is still not manageable to get up to the 10 percent level, try some other strategies. The key is to find ways to save. Most soldiers come into the Army with the GI Bill, which is a great investment in itself. These soldiers pay $100 a month for their first 12 months. Somehow they managed to survive without the $100 for their first 12 months; once the GI Bill is payed off why not earmark that money for savings since you are not used to having it already? For young soldiers, this will probably easily meet the 10percent goal. This is just a recommendation, but it will be transparent to you if you immediately begin this strategy upon paying off your GI Bill requirement. Placing $100 per month in an emergency account that is insured by the FDIC (Federal Deposit Insurance Company- your money is insured by the government up to $100,000) at a conservative 4percent interest rate (easily attainable through most money market accounts) will lead to the below results and be quickly accessible to you in an emergency. The chart below is designed to demonstrate the growth potential of saving $100 per month while only earning a 4percent rate of return.

	results of saving $100 per month					
Total years	5 Yrs	10 Yrs	15 Yrs	19 Yrs	21 Yrs	24 Yrs
results at 4% interest	$6,630	$14,725	$24,609	$34,067	$39,394	$48,226

Another strategy involves saving additional money each time you get promoted in the Army. Your promotions/raises are well earned; no one is saying you should try to live off the salary of a private for your entire military career. But again you can say this is money you are not used to having. You earned your promotion/raise and deserve to increase your standard of living. But why not dedicate a certain percentage (30-50 percent) of every raise/promotion to your emergency fund? This accomplishes two objectives - increasing your standard of living from your well-earned promotion/raise and at the same time increasing your savings with money you are not used to spending or having in the first place. You may think this is not worth it if it results in a small amount of savings, but everything helps! If you utilize this suggestion throughout your military career you will be amazed at the amount you can save. The chart below demonstrates the results of saving 30 percent of a particular pay raise at grades ranging from the grades of E1-E4. For example, if an E1 saves 30 percent of his/her first promotion to E2, this extra $37 dollars saved per month will amount to more than $14,000 at 22 years at a rate of return of 4 percent -- small amounts can make a difference. If you kept up this approach for each promotion throughout your career, you can imagine the results.

Results of saving 30% of promotion raises at 4% interest (based off of pay tables effective 1 Jan 2001)

	5 Yrs	10 Yrs	15 Yrs	19 Yrs	22 Yrs	24 Yrs
A typical E1 promoted to E2 gains an extra$126 a month. 30% of this is $37. Results of saving $37.	$2,453	$5,448	$9,105	$12,604	$14,575	$17,843
A typical E2 promoted to E3 gains an extra $45 a month. 30% of this is $13.50. Results of saving $13.50.	$895	$1,987	$3,322	$4,599	$5,699	$6,510
A typical E3 promoted to E4 gains an extra $116 a month. 30% of this is $34.80. Results of saving $34.80.	$2,307	$5,124	$8,563	$11,855		

Many soldiers receive tax refunds at the end of the tax-filing season. Fight the urge to spend all of this money by splurging on some impulse purchase. Instead, why not take half of that amount and save it and spend the other half as you wish? Receiving a tax refund and saving some part of it is the best example of the ‘pay yourself first’ principle. Somehow you managed the year without this money and were ’forced‘ to pay yourself first by unknowingly having too much taxes taken out of your paycheck. Think about it. For individuals that receive a big return this is a way to power up your emergency account- it just requires some discipline.

We have reviewed a few strategies you can use to attain the goal of saving 10 percent of your salary for an emergency fund. Try whichever you prefer or use a few in combination to reach the 10 percent goal. Remember the most important thing to do is to pay yourself first. This will leave less money for you to use on impulse buys. Keep in mind some of these charts may not be as impressive as those utilizing the higher expected returns investing in the stock market can achieve. The purpose of this emergency fund is security and liquidity, meaning the money is immediately available for use in the case of emergency or need. It is rarely wise to withdraw funds from a mutual fund during a down time, because you get less than what you paid in. During a good period in the stock market, you also lose the benefit of compound interest (unless you had reached your original goal for the investment), because this would eliminate your ability to keep the money growing at the higher rate return. This is a major reason you want to establish an emergency fund--to protect your investments when you are in a time of financial need.

When your car breaks down and needs repair, when your refrigerator or other major appliance breaks down, a family emergency occurs and you need to purchase an expensive plane ticket, or some other instance of need arises, it is better to borrow from yourself than use a credit card (as most of us do) or bank loan. Note the term ’borrow from yourself‘ as you should try to pay yourself back (discipline) to maintain this fund, but obviously the ’interest rate‘ you charge yourself will be a lot less than a credit card. This will save you from going into debt and experiencing further future financial problems that would likely occur if you had to fund an emergency with a credit card. Establishing an emergency fund is a key component to establishing financial independence. Through a little discipline you can be on the road to personal finance success.